



8-1-1959

Place of Variable Annuities in Law and Economics

John H. Dorsey

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

Recommended Citation

John H. Dorsey, *Place of Variable Annuities in Law and Economics*, 34 Notre Dame L. Rev. 489 (1959).

Available at: <http://scholarship.law.nd.edu/ndlr/vol34/iss4/1>

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.



THE PLACE OF "VARIABLE ANNUITIES" IN LAW AND ECONOMICS

*John H. Dorsey**

The Supreme Court has decided, by the narrowest possible margin, that "variable annuities" are "securities," not "insurance."¹ This is a simple statement of a conclusion of law. But its import rests on a complex of facts, federal statutes, economics and states' rights which gave rise to the issue.

Resolution of the legal issue was dependent upon the proper interpretation of three important federal statutes designed to protect the public, the investor and the public interest² as applied to a type of contract which came into being in 1952 — after all of them were on the books — and was labelled with the coined name "variable annuity," one without legal ancestry.

Perhaps no new financial vehicle since the birth of corporations has generated more legal controversy than the "variable annuity." Members of the securities business were insistent that the contract was a "security" within the meaning of that term as defined in the Securities Act.³ The insurance in-

* Mr. Dorsey was counsel for the National Association of Securities Dealers, Inc., in the litigation that recently culminated in a Supreme Court decision upholding the view of "variable annuities" advanced by him. Although Mr. Dorsey has tried to be objective in preparing this article, he suggests that readers should be aware of his advocacy of the opinions contained herein.

1 In the consolidated cases of SEC v. Variable Annuity Life Ins. Co., and National Association of Securities Dealers, Inc. v. Same, 359 U.S. 65, decided March 23, 1959. The named respondent will here be referred to as VALIC; the other respondent, The Equity Annuity Life Insurance Co., as EALIC; the SEC and National Association of Securities Dealers, Inc., jointly as SEC/NASD.

2 Securities Act of 1933, 48 Stat. 74 (1933), 15 U.S.C. §§ 77a-77aa (1952); Investment Company Act of 1940, 54 Stat. 789 (1940), 15 U.S.C. §§ 80a-1 — 80a-52 (1952); and McCarran-Ferguson Act, 59 Stat. 33 (1945), 15 U.S.C. §§ 1011-1015 (1952).

3 Section 2(1) provides: "When used in this title, unless the context otherwise requires — The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

dustry was split as to whether it was "insurance" and hence a proper product to be sold by insurance companies.⁴

Insurance Commissioners for the District of Columbia (1956), West Virginia (1956), Kentucky (1957) and Arkansas (1957) authorized the sale of "variable annuities" as insurance. In West Virginia, notwithstanding the authorization of the Insurance Commissioner, the State's Security Commissioner initiated an action to enjoin the sale unless the sellers complied with the State's Securities Law.⁵ The Supreme Court of Errors of the State of Connecticut held that "variable annuities" do not qualify as insurance in that State.⁶ Persistent efforts to have state laws amended so that "variable annuities" can qualify as insurance have met with no success.⁷

⁴ The presidents of the country's two largest insurance companies, The Metropolitan Life Insurance Company and the Prudential Life Insurance Company, were, for example, on opposite sides of the fence. See Ecker, *The Case Against Variable Annuities*, *Dun's Review and Modern Industry* (Oct. 1956); and Shanks, *Do Variable Annuities Meet the Need?* *Dun's Review and Modern Industry* (Sept. 1956). Insurance technicians, likewise, were of differing opinions. See, for example, I PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 162-65 (1956).

⁵ *State v. Variable Annuity Life Ins. Co.*, Circuit Court of Kanawha County, W. Va., Docket No. 24,449. This case was tried July 21-22, 1958. As of the date of this writing the court still has the case under advisement.

⁶ *Spellacy v. American Life Ins. Ass'n*, 144 Conn. 346, 132 A.2d 834 (1957).

⁷ Legislation Which Would Have Authorized Sales of Variable Annuities to Public:

State	Year	Bill	Disposition
Connecticut	1957	House 1427—to incorporate the Equity Life Insurance Company.	Joint Hearing March 21, 1957. Referred by House Joint Resolution 170 to Legislative Council for study.
Maryland	1955	House 597—to incorporate the Variable Life Income Corporation of Maryland.	No action.
		House 730—to provide for the establishment and operation by Life Insurance Corporations of a variable contract account, etc.	Passed House. Died in Senate Committee.
Massachusetts	1956	House 1560—to authorize life insurance companies to establish variable contract accounts, etc.	Joint Hearing February 6, 1956. No transcript was made. Referred to Special Commission for study by House 2716.

Special Commission held public hearings on April 30 and May 1, 1957 to consider House 1560. No transcript of these hearings was made but the Special Commission issued its report covering these hearings on December 2, 1957 as Massachusetts Senate Document 556 of 1958. In this report the Commission recommended further study, looking toward affirmative legislation authorizing the issuance of annuities based upon some portion of equity investment.

The Special Commission held another public hearing on May 28, 1958 to discuss, among other things, variable annuities. Speakers were re-

It is the purpose of this article to take the reader behind the scenes of the Supreme Court opinion to give some insight into the history of the "variable annuity" and the gestation of the test case.

<i>State</i>	<i>Year</i>	<i>Bill</i>	<i>Disposition</i>
			requested to confine their remarks to developments on the subject since the hearing approximately one year before. No transcript was made. The Special Commission issued its report dated July, 1958 as Senate Document 815. The Special Commission reported, without recommendation, a variable annuity bill as Appendix B to its report (S. 815).
	1958	Senate 815 App. B—to authorize life insurance companies to establish variable annuity accounts.	Referred to Special Commission for study by Senate 842. This bill was the subject of a public hearing by the Massachusetts Joint Insurance Committee on September 29, 1958. No transcript of this hearing is available.
New Hampshire	1955	Senate 69—to authorize life insurance companies to establish variable contract accounts.	Killed in Senate on March 24, 1955 after hearing before the Senate Committee on Banks and Insurance.
New Jersey	1955	Assembly 305, 306, 307.	Public hearing before the Assembly Committee on Business Affairs May 13, 1955. Transcript available. Died in Assembly Committee.
	1956	Assembly 450, 451, 452.	Public hearing before the Senate Committee on Business Affairs June 22, 1956. Transcript available. Passed Assembly; died in Senate Committee.
	1957	Assembly 11, 12, 13.	Passed Assembly; died in Senate Committee.
	1958	Assembly 330, 331, 332.	Public hearing on May 2, 1958 before the Assembly Committee on Business Affairs. Transcript available. Passed Assembly; in Senate Committee.
New York	1954	Assembly 1323 (Senate 2681)—to incorporate Variable Annuity Corporation of America.	Passed both houses. Vetoed by Governor Dewey.
	1955	Senate 1352 (Assembly 1657)—to incorporate Variable Life Income Corporation of America.	Passed in Assembly. Bill died in Senate Committee.
	1957	Assembly 4044—to incorporate Variable Life Income Corporation of America.	Died in Assembly Committee.
Texas	1955	Senate 332 (House 737)—providing for the formation of corporations for the purpose of issuing variable annuity contracts.	Died in Committee.

I. THE GENESIS OF THE "VARIABLE ANNUITY"

Teachers Insurance and Annuity Association of America (TIAA), a legal reserve life insurance company *selling only to college staff members*, made exhaustive economic, actuarial and legal studies of the retirement problem of its annuitants.⁸ It came to the conclusion, which cannot be the subject of dispute, that fixed dollar annuities purchased twenty to thirty years in the past had failed, because of inflation, to provide the contract-holders with the financial protection after maturity date which had been anticipated. As a result it decided to supplement the legal reserve life insurance annuity by offering to college staff members "A new method of providing retirement income through periodic investments in common stocks and the payment of a variable, or unit, annuity in combination with a traditional fixed dollar annuity."⁹ In effectuating its decision, TIAA, in apparent recognition that the scheme was not insurance, set up an independent entity called College Retirement Equity Fund (CREF), to administer the common stock investment fund. Under the plan a participant was and is required to have a minimum 50% of the payments credited to his account made applicable to the purchase of a fixed dollar annuity in TIAA. Any other portion of the payments to his account up to 50% he can elect to have invested for him in CREF, in which each payment will purchase for him pro rata shares in CREF's investment portfolio at current value. CREF deducts all expenses from the fund. Although the participant is credited with shares in the fund ("units"), these shares have no cash or loan value. Should the participant survive after a retirement date specified in the contract he receives a monthly pension payment until death which is computed on the basis of the month to month investment experience (realized and unrealized gains and losses plus income) of the fund. Thus the participants are saddled with the risk of the fund's investment experience. To the end of 1956 CREF had issued contracts to more

The table appearing above summarizes only those bills which would have authorized life insurance companies, or new companies known as life insurance companies, to sell "variable annuities" to the public. It does not include pension plans, which are not insurance, and do not and could not qualify under general insurance laws, such as:

1. The College Retirement Equities Fund (CREF), sold only to college professors. By Special legislation CREF was authorized to do business by the State of New York subject to regulation and control of its Insurance Commissioner under four provisions of the State's general insurance laws (An Act to Incorporate College Retirement Equities Fund for the benefit of the teaching profession, N. Y. Laws 1952, C. 124); or
2. Three bills passed by the Wisconsin Legislature in 1957 which incorporated the "variable annuity" principle into the retirement systems for state employees, state teachers and the teachers of Milwaukee on much the same basis as CREF, Wisconsin Laws 1957, Chs. 322, 381, 423; or
3. Two bills introduced in the Massachusetts legislature (S. 341 and S. 815) (both of 1958) which are essentially "variable annuity" bills but limited to group business.

⁸ APPROACH TO RETIREMENT INCOME, published by TIAA in 1955, which is described on the fly leaf as:

"An economic Report prepared by William C. Greenough, Ph. D., vice president of Teachers Insurance and Annuity Association of America, as background for its proposed COLLEGE RETIREMENT EQUITIES FUND."

⁹ *Id.*

than 31,000 college staff members and the value of its shares has increased from \$10 to \$18.51. It is a matter of general knowledge that this period has been one of inflation and prosperity and that common stock averages have sky-rocketed. But the spread from \$10 to \$18 cannot be considered a profit per share for all participants. One purchasing a share in 1956 was required to pay \$18 for the same share which sold in 1952 for \$10; and those who purchased in between paid the then current value of a share. Should the inflationary trend continue the participant can hope that his pension will exceed what he would receive under a fixed dollar annuity and to some extent ease the financial pains of inflation. On the other hand, because he is required to have also a fixed dollar annuity, he will not be destitute in a period of deflation.¹⁰

CREF did not qualify under the general insurance laws of any state. It was incorporated by special legislation in the State of New York, which made it subject to the supervision of that State's Insurance Commissioner *under only four provisions* of the voluminous general insurance laws of that State.¹¹

¹⁰ See an Address to the Church Pension Conference, Dec. 4, 1958, on Variable Annuities, by Wilmer A. Jenkins, Executive Vice President, TIAA and CREF, in which he details the pros and cons of CREF. Cf. the following, excerpted from a proposal of Robert Slater, Vice President, John Hancock Mutual Life Ins. Co., which is included in the 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 413 (1957):

The variable annuity contract as such departs from the traditional life insurance principle of guaranteed or fixed benefits. It does, however, represent a solution to more of the problems affecting the group annuity business than any other plan devised to date. The variable contract does have some disadvantages although they may not disqualify such a contract in its entirety by any means. For example:

- (a) The variable contract assumes that over the long-term period the rise in the value of stock market prices should equal or exceed the increase in the cost-of-living. This point is not in dispute historically, but as fluctuations in the stock market are not directly proportionate to trends in the cost-of-living, the past may not be a portrayal of the future;
- (b) while over long periods of time reasoning from the relationship of stock prices and the cost-of-living may be sound, it is not sound over short periods of time — the period of time, from month to month, with which retired people are most concerned. People must live from month to month on their pension checks and sharp temporary fluctuations in the market can affect their ability to meet living expenses. Recently several sharp breaks in the market value of common stock have coincided with such events as the —
 1. heart attack of President Eisenhower;
 2. Middle East crisis;
 3. change in interest rates;
 while at the same time the cost-of-living index has been rising. Consequently, an annuity geared too closely to stock prices can operate over relatively short periods of time differently than for the long-term trend;
- (c) if employers wish to finance more of their pension costs through the medium of equity investments, they should be permitted to do so. If, however, it turns out that this was not the best way to do so, it hardly seems fair or equitable to have the retired employee pay the price for this error in judgment. Employers as corporations are a continuing entity and may be in a better position to absorb the costs of fluctuations in the stock market than are the retired employees;
- (d) it will be very difficult to explain to individuals why an annuity supposedly geared to provide for an increase in cost-of-living is on some occasions decreasing in amount when the cost-of-living is actually increasing. This will be true regardless of whether the annuity arises from an individual or a group annuity.

¹¹ See "An Act to incorporate College Retirement Equities Fund for the benefit of the teaching profession," N.Y. Sess. Laws 1952, ch. 124.

That this was special legislation in a true sense and that the product sold was fraught with potential abuses which could be inimical to the purchaser and the public interest is suggested by the fact that the New York Legislature has since the advent of CREF refused on three occasions to authorize the incorporation of companies to sell "variable annuities" to the public.¹²

II. THE COMMERCIAL AND ECONOMIC ATTRACTIONS OF THE "VARIABLE ANNUITY"

In the 1930's and early 1940's most new pension programs were financed through group annuities (fixed guaranteed dollars) written by life insurance companies. Few were placed with trust companies or self-insured by the employer. Today the vast majority of new pension plans are either self-insured by the employer or placed with trust companies under a trust agreement. Life insurance companies are finding it necessary to spend considerable time and money merely to conserve business in force.¹³

In past decades pension plans, in the main, were the sole responsibility of management. Today this is no longer the case. Labor, under collective bargaining agreements, either has or is seeking an equal voice in the administration of pension plans. Provisions of these programs are subject to change from bargaining session to bargaining session. Consequently, contracts similar to those issued by life insurance companies, *i.e.*, heavily weighted with specific guarantees to the employee, do not have the flexibility required in making changes in pension plans from time to time. In fact, the only guarantee desired in many of the current pension programs is the guarantee given by the employer. If commitments provided are inflexible, they tend to make pension programs sources of future collective bargaining difficulties. Assets of insurance companies cannot in any way be segregated for group annuities and, as a result, in some instances an employer depositing or withdrawing funds at a time advantageous to him can do so to the disadvantage of the large body of individual insurance policy owners.

Funds presently placed with life insurance companies, regardless of the purpose for which they are deposited, must be invested in those securities designated by law. Investment and other regulations made many years ago for individual insurance were also made applicable to group insurance when it came into existence. Life insurance companies must conform to the restrictions placed upon them by the State in which they are domiciled and also to those in force in States where they do business. New York, for example, seriously limits the extent to which a domiciled company may invest in common stock. "Foreign" companies operating in New York must conform substantially to the New York requirements. There can be no special funding, *i.e.*, a given investment must be held for all insurance obligations regardless of whether the obligations differ in nature. A company, for example, could not make an arrangement with an employer to place more of his pension

¹² See footnote 7, *supra*.

¹³ *Cf.* a proposal by Robert Slater, Vice President, John Hancock Mutual Life Insurance Company, for the issuance of group annuities with a special funding provision, 2 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 410-17 (1957).

funds in common stocks than is held for the general insurance obligations of the company. In most states the percentage of assets permitted in equity investments is very low. Consequently, the resulting inflexibility of investment policy imposed by state law is not conducive to encouraging employers to finance their pension plans through life insurance companies. As a matter of fact, the use of equities in conservative long-term investment programs is not a new or untried practice.

Attempts have been made to overcome these problems within the scope of present state regulatory laws, as previously mentioned, by introducing contracts having names such as Deposit Administration or Pension Administration. Because of the rigidity of state regulation, which prevents flexibility of investment policy, the net result has been that although these contracts have solved some of the problems, they have not reduced the major disadvantages under which life insurance companies presently operate in the pension field. New business has not increased but actually has decreased in spite of the great growth in pension programs.

In the life insurance industry, which does not lack leaders of great business acumen, there are some who visualize a commercial adaptation of the CREF plan ("variable annuity") which would restore the industry to a favorable competitive position in attracting pension fund business with little risk of financial loss. Since the risks of investment experience would be borne by the pensioners, the only risks which the companies would take is that their self-determined loading charges would not cover expenses or unfavorable mortality experience. Since the annuity mortality table is unilaterally selected by the company and can be a "conservative" one, the latter risk can be minimized.

III. A COMMERCIAL VERSION OF A "VARIABLE ANNUITY"

The term "variable annuity" has no precise meaning that can be reduced to a lexicographer's definition. Instead it refers to a scheme capable of innumerable ramifications. To avoid the pitfalls of generalization by definition we substitute a description of the terms of VALIC's "Deferred Variable Annuity Policy," which was received in evidence in the test case and considered by the courts as a specimen of the contracts that employ such investment practice.

A. *Provisions of the "Variable Annuity" Contract*

The purchaser of a "Deferred Variable Annuity Contract," whom we shall refer to as "the investor" (referred to in the contract as "the annuitant"), agrees to make specified periodic payments to VALIC during a stipulated period from ages 0 to 70 years. After deducting "loading charges" that are retained by VALIC for expenses and profits,¹⁴ the net remaining from each payment is invested by VALIC in a fund for the account of the investor. This fund is exclusively managed, controlled and operated by VALIC. The con-

¹⁴ The "loading charge" for the first year exceeds 50% of the payment available for purchase of "accumulation units." See concurring opinion of Mr. Justice Brennan, 359 U.S. at 82.

tract contains no specification of the manner in which VALIC is to invest the capital thus made available to it nor the precise manner in which investment increments, if any, are to be distributed to investors.

At the time of each payment the investor purchases and is credited with a number of shares in the fund (referred to in the contract as "accumulation units"), determined by dividing the current value of a share at the time of payment into the net payment. The value of the shares fluctuates with VALIC's investment experience. The contract provides that at least once each year VALIC shall notify each investor of the total number of shares ("accumulation units") credited to his account and the dollar value of each share as of the date of notification.

Throughout the period during which the investor makes periodic payments (referred to herein as the "accumulation period") he may at any time cash in his shares at current value (this the contract calls "cash value") as a result of which he may realize a profit or loss. During this same period the investor may cash in a portion of his shares at current value (this the contract calls a "policy loan"). If he reinvests (repays) what the contract terms a "policy loan" he is not necessarily credited with the same number of shares he cashed in. Instead, his "repayment" purchases shares at their current value as of the date of "repayment." Thus the investor may on "repayment" acquire a greater number of shares than he would have had if he had not entered into the "loan" transaction, or a lesser number. This is in contrast to true insurance policies or annuity contracts which set forth and guarantee *fixed* "cash values" and "loan values."

During this period the investor may also speculate by taking advantage of the so-called "Grace Period" and by making payments "on or before" the due date provisions of the contract. VALIC establishes the dollar value of a share ("accumulation unit") as of the last day of each month. If the investor is of the opinion that the dollar value of a share will decrease by the end of a given month he can withhold his payment until the next month. If he guesses right he will receive more shares for the same payment. If he thinks the dollar value of a share will increase in the future he can make advance payments and purchase shares at current value.

Throughout the period during which the investor is making payments to VALIC there is no life or other insurable contingency involved. The investors provide the capital, share in the earnings and profits, and bear the risk of loss resulting from investment of their funds by VALIC.

By contrast, investment and mortality prognostications are used by an insurer to fix its selling price. The risk that premium rates plus future realized investment income may prove to be inadequate is borne by the insurer; and, should that result come about, it does not affect the contractual obligation of the insurer to the insured upon the occurrence of the insurable contingency.

The "variable annuity" contract does not obligate the investor to participate in the investment fund to any further extent than that set forth above. It does give the investor an election to take cash or to purchase a so-called "variable annuity" between the ages of 50 and 70 years. If he elects the "variable annuity," he makes a "capital payment" to VALIC computed by

multiplying the number of shares ("accumulation units") credited to his account times the current value of a share. For each \$1000 of this payment VALIC pays him a *first* monthly payment of less than \$10 per thousand, computed on the basis of the Progressive Annuity Mortality Table at 3½% interest.¹⁵ In a true annuity contract computed on the same basis the *same* monthly amount, guaranteed at the inception of the contract, would be paid to the annuitant for the entire term.

After the *first* monthly payment the investor is assured no specific, or even any, subsequent monthly payments during the term of the contract. Instead, he is credited with a number of shares (called "annuity units") in the investment fund.¹⁶ The future value of these shares ("annuity units") is speculative in that *all* monthly payments, *if any*, subsequent to the first, are computed by the formula number of shares times the current monthly value of a share resulting from VALIC's operation, management and control of the investment fund. Before the investor's interest can be known, VALIC deducts, as a prior charge, a management fee (1.8% per annum), and investment taxes (undescribed in the contract and of uncertain amount). The investor is paid each month for life, or other optional term, the uncertain future current monthly value, *if any*, of a share ("annuity unit") times the number of shares credited to his account. VALIC is legally indifferent what the value of a share, each month, may prove to be. The contract does not *assure* the investor that he will have a fixed dependable income, or any income, for the remainder of his life. Instead, he has only the hope of gain and bears the risks of loss.

B. Insurance Benefits, If Included in the "Variable Annuity" Contract, Are De Minimis, Separate and Severable

VALIC requires that the purchaser of a deferred "variable annuity" contract, *if insurable* and within certain age limits, purchase a contract for 5-year decreasing term life insurance. Its "General Information and Rates" book states:

All individual deferred annuity policies will be issued with a minimum amount of life insurance on the annual decreasing term plan unless the applicant fails to meet the Company's insurability requirements. In the case of *annual* premium policies, the initial amount of insurance in the first policy year will be equal to five times the annual basic annuity

¹⁵ From the inception of the contract to the date of election the investor cannot know what capital he will have acquired, for he cannot foresee how many shares ("accumulation units") he will have purchased or their value as of the date of election. Since, as admitted by VALIC's actuary and a member of its Board of Directors, VALIC does "not guarantee the investment experience" it stands legally indifferent whether the value of the shares held by the investor at the date of election is more or less than the total amount invested. The investor has only the hope that VALIC's management, operation and control of the investment fund in which he has an aliquot share will result in a profit and not a loss.

¹⁶ The number of "annuity units" credited to the purchaser's account is determined by dividing the first month's guaranteed payment by the current value of such unit. The number of units remains constant for the balance of the term of the contract. One who elects to purchase a "variable annuity" contract when the value of an "annuity unit" is low will have more such units credited to his account than another making the the same capital investment under the same contract when the value of the unit is high. The former, owning more shares, will receive larger payments than the latter in the same month (since each unit has the same value) although each has invested an identical amount of dollars.

premium. In the case of *single* premium policies, the amount of life insurance in the first policy year will be equal to one-half of the single premium. In both the annual and single premium cases, the amount of insurance will decrease one fifth each year until at the end of the fifth year it will be zero.

...

... Individual policies without life insurance will be issued to:
(1) applicants from age 61 to 70, inclusive; and (2) from age 0 to 60 on uninsurable applicants.

An investor may also *elect* to have included in his contract as a rider "A total and permanent disability premium waiver benefit."

It was conceded at the trial that the 5-year decreasing term life insurance and the total and permanent disability premium waiver benefit are true insurance. But VALIC sells the bare "variable annuity" without such insurance.

In those cases where the investor satisfies medical requirements and purchases one or both of the aforementioned types of insurance, the premium for the coverage is deducted from the amount he would otherwise have available for purchases of shares ("accumulation units") after VALIC has deducted its loading charges. Compared to the total payments made by the investor this amount is *de minimis*. In the case of the specimen contract, which provides for the investor's payment of \$1000 per year to VALIC, the cost of the 5-year decreasing term life insurance over the 5-year period would be \$100.85, equal to a little over 2% of the total payment of \$5000; and if the contract remained in force for 30 years of payments by the investor, out of total payments amounting to \$30,000 only \$100.85 or 3/10 of 1% would be applied to life insurance premiums. The disability premium is \$39.60 per annum.

VALIC's book "General Information and Rates" indicates that it offers at the option of the purchaser of a "variable annuity," additional term insurance. There was no evidence that VALIC has ever sold such insurance.

The District Court, in its findings of fact, found that "The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks." The Court of Appeals found that the life insurance contracts sold by VALIC "are a small part of its total business" and are "irrelevant to the question of the nature of the predominant annuity feature of the policy."¹⁷

C. *The Format of and Terms Used in VALIC's "Variable Annuity" Contract*

VALIC's "variable annuity" contracts are printed in a format usually associated with insurance contracts. Found in them are insurance terms such as "cash value" and "loan value," but by definition therein they differ from and are at variance with the usual insurance meaning of the terms. Also found in the contracts are insurance terms such as "The Death Benefit," "The Beneficiary," "Grace Period," "Protection from Creditors," "Incontestability,"

¹⁷ 257 F.2d 201, 203 (D.C. Cir. 1958).

"Suicide." Most of these can apply only to the 5-year decreasing term life insurance (if included in the contract) and are not relevant to the "variable annuity" provisions of the contracts.

The terms in the contract which are the vitals of its so-called "variable annuity" are "gross investment rate," "net investment rate," "net investment factor," "accumulation unit," "value of an accumulation unit," "annuity unit," and "annuity unit value." These terms are not found in insurance nomenclature.

IV. SALES LITERATURE AND TECHNIQUES

Second only to the "variable annuity" contract itself in probative value as to its legal and economic character are sales literature and techniques used in promoting sale of the product. Such are persuasive evidence as to whether the sales appeal emphasizes the hope or expectation that a profit will accrue to the purchaser as a result of the seller's management of a securities portfolio.

The sales literature of both respondents in the test case, it would appear, was designed to imply that their "variable annuity" contracts were insurance against the economic ills of inflation. For example, brochures captioned: "Retirement with Protected Purchasing Power" — "Inflation-Proof Annuities," — contained statements that this was to be accomplished by investing the purchaser's money in a portfolio of common stocks which "will provide an income which will tend to keep pace with the cost of living." The purchaser would have a "proportionate ownership" in the fund reflected by shares which he purchased at current values, the shares being called "units." EALIC, which stipulated that its "variable annuity" contracts were in all material respects the same as VALIC's, in a brochure, "Equity Annuity — a new road to Security," described the scheme:

Our variable annuity program is designed to minimize the speculative features of common stock investments. You avoid the gamble of buying a single stock . . . [T]he company "spreads the risk" by buying stocks in *many* of the nation's leading corporations . . . You avoid the risk of buying stocks on a "hot tip". Instead you benefit from the counsel of expert financial advisers . . . in short you get the benefit of expert diversification.

Let us look at an example of VALIC's sales techniques. Using two stock price indices entirely unrelated to VALIC activity ("Standard and Poor's Weekly Composite Index of 480 stocks for price and Standard and Poor's Daily Composite Index of 90 stocks for yield"), VALIC presumed to show a prospective purchaser how he would have benefited had he invested in a "variable annuity" instead of a conventional annuity during the period 1940-1955. The tables and graph set forth in the exhibit are based, not upon the experience of VALIC, but upon stock market averages of securities which differed substantially from VALIC's portfolio. VALIC obviously used this technique to imply future results.

A comparison of the sales literature's statements and implications as to what the "variable annuity" contract provides and the actual provisions of the contract revealed that the contract does not insure "Retirement with Pro-

ected Purchasing Power," or against losses resulting from inflation or increase in costs of living, or "an annuity income that cannot be outlived." It does not even mention these objectives.¹⁸ The only guarantee in the contract is a *first* monthly payment of less than \$10 for each \$1000 of capital payment (the amount of which is unforeseeable until the month of election). Every provision for subsequent monthly payments by VALIC is conditioned on its investment experience.

The contract does state that "The company guarantees that the dollar amount of such installments after the first (monthly payment) shall not be affected by variations in the actual mortality experience of payees from the mortality experience assumptions of the Progressive Annuity Mortality Table." This is meaningless. The contract itself explicitly obligates VALIC to pay an amount equal to the product of the current value of each "annuity unit" times the number of such shares credited to his account. It follows that the quoted reference to mortality is a mere redundancy because experienced departures from the expected mortality, whether in the direction of longer or shorter life, could have no effect on the operation of the basic formula which describes VALIC's obligation to pay under its contract.¹⁹

V. THE ISSUES IN THE TEST CASE

Being of the opinion that the "variable annuity" is a "security" within the meaning of that term as defined in Sec. 2(1) of the Securities Act²⁰ and that each of its issuers was an "investment company" within the meaning of that term as defined in Sec. 3(a) of the Investment Company Act,²¹ the SEC initiated an action to enjoin VALIC from violating the registration provisions of the Securities Act²² and the Investment Company Act.²³

On their own motions NASD²⁴ and EALIC intervened on the sides of the plaintiff and defendant, respectively.

In their answer VALIC and EALIC admitted that they sold and were selling and offering for sale "variable annuity" contracts through the mails and means of instrumentalities of interstate commerce and that they had not complied with the Federal securities laws. They denied that the "variable

¹⁸ While "inflation," with its attendant increase in the cost of living and depreciation in the value of the dollar, may be an insurable contingency, the "variable annuity" contract does not indemnify or guarantee against loss therefrom.

¹⁹ The Court, in *SEC v. VALIC*, described VALIC's assumption of the mortality risk as "... apparent, not real; superficial, not substantial." 359 U.S. at 71.

²⁰ 48 Stat. 74 (1933), 15 U.S.C. 77b(1) (1952). The definition is set forth in footnote 3, *supra*.

²¹ 54 Stat. 789 (1940), 15 U.S.C. 80a-3(a) (1952):

Sec. 3. (a) when used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

²² 48 Stat. 74 (1933) §§ 5(a)(1) and 5(c); 15 U.S.C. §§ 77e(a)(1) and 77e(c) (1952).

²³ 54 Stat. 789 (1940) § 7; 15 U.S.C. § 80a-7 (1952).

annuity" is a security and that they are investment companies. Affirmatively they pleaded that: (1) the "variable annuity" contract is "insurance" and an "annuity contract" exempt from registration by § 3(a)(8) of the Securities Act;²⁵ (2) each is an "insurance company" exempt from registration by § 3(c)(3) of the Investment Company Act;²⁶ and (3) the offering for sale and the selling of such contracts is "the business of insurance" exempt from Federal jurisdiction by the McCarran-Ferguson Act.²⁷ Thus the pivotal issue framed by the pleadings was whether the "variable annuity" contract was "insurance" within the meaning of that term as used undefined in the Securities Act, the Investment Company Act, and the McCarran-Ferguson Act.

The respondents contended that: (1) the contract was "insurance" because they were chartered as insurance companies and the contracts had been approved by insurance commissioners in the states in which they were authorized to do business; (2) they were subject to regulation by these commissioners; (3) this regulation was sufficient to protect the public interest; (4) the contracts included all the provisions prescribed by the insurance laws for the District of Columbia; (5) their investments were regulated by such laws (in the District of Columbia the insurance laws do not limit the amount that an insurance company may invest in common stocks); and (6) they used a mortality table and were committed to make "variable annuity" payments over the uncertain life span of the contract holder.

The SEC/NASD countered: (1) the term "insurance" is used in the Federal statutes in its commonly accepted sense; (2) risk-shifting is essential to an insurance contract;²⁸ (3) the "variable annuity" is not "insurance" because it lacks the legally indispensable element of risk-shifting; (4) the printing of a contract in a form that looks like an insurance policy and the use of insurance terms therein do not make a contract "insurance";²⁹ (5) mortality

²⁴ NASD is a duly organized national securities association registered with the SEC (5 S.E.C. 627 (1939)) exercising Congressionally delegated powers in the over-the-counter securities market conferred by the Securities Exchange Act of 1934 48 Stat. 881 (1934) § 15 A, 15 U.S.C. § 780-3 (1952).

²⁵ Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

.....
Sec. 3.(a)(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

²⁶ Sec. 3. (c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

(3) Any bank or insurance company

This must be read in conjunction with the section defining "Insurance Company":

Sec. 2. (a)(17) 'Insurance Company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

²⁷ VALIC and EALIC were chartered as stock life insurance companies in the District of Columbia in 1955 and 1956, respectively. There was no dispute that their primary and predominant business was the sale of "variable annuities."

²⁸ *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941); *Jordan v. Group Health Ass'n*, 107 F.2d 239, 244-45 (D.C. Cir. 1939); *Commonwealth v. Wetherbee*, 105 Mass. 149 (1870).

²⁹ *Helvering v. Le Gierse*, *supra* note 28 at 541.

tables are used by an insurer in conjunction with future estimated income as a kind of a cost accounting device to fix its selling price, are not part of an insurance contract and do not affect the legal obligation of an insurer to pay the insured upon the occurrence of the contingency insured against; (6) there is nothing in the Federal securities laws or the McCarran-Ferguson Act which suggests that the Congress gave State insurance commissioners the power to determine that a given contract is one of "insurance" and thereby to exempt it or its issuer from compliance with such laws; (6) Congress had prescribed how securities were to be regulated foreclosing the argument as to whether regulation by insurance commissioners would adequately protect the investor, the public and the public interest; and (7) the McCarran-Ferguson Act exempts only "the business of insurance" from federal regulation and not necessarily the business of companies that happen to have been chartered as insurance companies.³⁰

VI. THE "VARIABLE ANNUITY" CONTRACT IS NOT INSURANCE BECAUSE IT LACKS THE INDISPENSABLE ELEMENT OF RISK-SHIFTING

A. *The Risk Shifted by Insurance or an Annuity*

Insurers, in connection with life insurance and annuity contracts, insure against the hazards attendant on the uncertainties of the life span. The two types of contracts are equated in the insurance concept because of the elements of *certainty* and *mortality* that inhere in both.

An insurer that sells both life insurance and annuities is selling certainty to its policy holders, despite that fact that each individual has a life of uncertain duration; certainty that the dependents of the insured will have a definite amount of money if he dies; and certainty that the annuitant will have a *fixed* dependable income after a certain age for the continuing years of his life.³¹ From the viewpoint of the insured, life insurance is assurance against loss from early death; annuity, loss from longevity.³²

Unless the risk of loss attendant on death or longevity is contractually shifted to and assumed by an insurer, the contract, notwithstanding its label or the corporate charter of the issuer or any other criterion, is not insurance. From what source or through what economic methods the insurer acquires the money to meet its contractual obligations is no part of an "insurance" contract. The contract fixes only the insurer's obligation to pay.

³⁰ To hold that simply because an entity is chartered as an insurance company it can avoid federal regulation of any activity that it can persuade a state insurance commissioner to approve is incompatible with the language and purpose of the federal laws. It would make any *one* insurance commissioner the arbiter of federal jurisdiction insofar as insurance companies are concerned.

³¹ *Accord*, HUEBNER, LIFE INSURANCE 130-32 (4th ed. 1950).

³² HUEBNER, *op. cit. supra* note 31, at 3, 91, defines "life insurance" and "annuities" thus: From the standpoint of the individual, however, life insurance may be defined as consisting of a contract, whereby a stipulated compensation, called the premium, one party (the insurer) agrees to pay the other (the insured) or his beneficiary, a *fixed* sum upon the happening of death or some other specified event.

* * *

An annuity therefore represents the purchase of a *fixed* income (monthly, quarterly, semi-annually, or annually) and the general purpose of the contract is seen to be the reverse of that accomplished under life insurance.

B. The "Variable Annuity" Does Not Shift the Risk of Loss Attendant on the Contingency of Longevity.

In the accumulation period, during which the purchaser of a "variable annuity" contract is making payments to the issuer, there can be no question that the issuer's operations are those of an investment company.³³ The contract purchaser is then an investor in every sense of the word. The purchaser supplies the capital, purchases shares in an investment fund which he may cash in at any time at current value, and is dependent upon VALIC's exclusive management, operation and control of the fund. The value of his shares fluctuates with the fund's investment experience. It is a purely speculative venture in which the purchaser has only the hope of gain and bears the risk of loss. Does this investment venture become "insurance" because the participant *elects* at a future time to become a party to the "variable annuity" period of the contract? It does not; for if he so elects he agrees to purchase shares ("annuity units") in the same investment fund, at current value, and for the term of the contract (from date of election to date of death of the participant, or other optional term) and the issuer agrees to make him an uncertain payment, the amount of which is dependent upon its future, month to month, investment experience resulting from its exclusive management, operation and control of the investment fund.³⁴

During this "variable annuity" period, the issuer does not guarantee that any payments will be made to the shareholders or that capital which they have supplied will not be dissipated by investment losses.

Reference in a "variable annuity" contract to an annuity table and a provision that payments to shareholders will not be decreased because mortality of shareholders may be less than indicated by the table are meaningless when analyzed. The Progressive Annuity Table at 3½%, referred to in the specimen contract, is used for one purpose only; to determine the first monthly payment to be made to the contract holder, which in all contracts is less than \$10 per \$1000 of capital investment.³⁵ The total *first* monthly payment thus determined is then divided by the current value of an "annuity

³³ See concurring opinion of Mr. Justice Brennan, 359 U.S. at 85.

³⁴ Compare the classic description of the rights of an insurance policy-holder appearing as follows in *People v. Security Life Ins. & Annuity Co.*, 78 N.Y. 114, 123 (1879):

The fund produced by the payment of all the premiums does not in any sense belong to the policy-holders but belongs exclusively to the company; and the policy-holders are interested in it in the same way only that the creditors of any other corporation are interested in its fund.

with the following from District Court's opinion, 155 F. Supp. at 524:

Where as the money paid for conventional insurance becomes the absolute property of the insurance company, the money paid for a variable annuity goes into an investment fund which becomes, by operation of law if not by express terms of the contract, a trust fund for the equitable interests of the contract holders.

See also 8 COUCH, CYCLOPEDIA OF INSURANCE LAW, §§ 2043-2045.

³⁵ This could hardly be held to be a substantial risk assumed by the issuer. Cf. *Keller v. Commissioner of Internal Revenue*, 312 U.S. 543 (1941).

³⁶ Reference to a mortality table is not necessary to effectuate the "variable annuity" scheme. Promoters could establish any arbitrary table of first monthly payments, at any specified age, per \$1000 invested and employ VALIC's formula of dividing the total first monthly payment by current value of an "annuity unit" and thus determine the number of "units" (shares) purchased. Whether the VALIC formula (which employs a mortality table) or an arbitrary table is employed does not affect the principle of the transaction.

unit" share and the resulting number of shares is purchased by the investor and credited to his account. Ownership of these shares, with their uncertain future monthly value, is all that the purchaser receives for his capital payment.³⁶ Subsequently, payments for the term of the contract, *if any*, depend upon the issuer's investment experience.³⁷

A statement in the contract that the issuer guarantees that the dollar value of "annuity unit" shares will not be affected by "variations in mortality experience" is redundant.³⁸ By specific provision in the contract, the issuer takes the calculated risk that the number of outstanding shares may require it to dip into its surplus, if any, or the capital contributions of its shareholders. This is a risk taken by an entrepreneur; it is not an "insurance" risk in the sense explained in *Helvering v. LeGierse*:

Historically and commonly insurance involves risk-shifting and risk-distributing . . . That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.³⁹

That risk-distributing, even coupled with a life contingency, does not make a contract insurance may be demonstrated by an illustration: A person who buys a pari-mutuel ticket at a race track participates in a scheme for risk-distribution. If the track should require, as a condition of collecting (should he prove lucky enough to have his horse win), that he be alive and personally present the ticket at the pay-off window, he would also participate in a scheme involving a life contingency. But it would not be insurance. VALIC's "variable annuity" contract differs in detail but not in substance from the illustration. Both entail speculation — in the pari-mutuel on a horse winning a race, in the "variable annuity" on VALIC's good luck or skill with its investments. In both, the availability of a sum to collect is contingent not on survival alone but on a speculative chance as well. In both, the amount collected, *if any*, is not related to or indemnification for any loss occasioned by the insurable contingency of continuing life beyond a specified age.

³⁷ In the specimen contract if VALIC begins with a fund which, with a 3½% "net investment rate," is sufficient to maintain level payments to a group of individuals, then if the net investment return is actually zero instead of 3½%, no investment return will in fact be distributed and the successive payments will become smaller and smaller. Since there is no investment income to be distributed, only the original fund will be distributed; and the original fund will be lessened by VALIC's management fee of 1.8% per annum and such amounts as it may be required to pay for investment taxes. If there is actual capital loss on investments, in excess of income, then it is obvious that not all of the original fund will in fact be distributed to the contract holders, since part of it will never be available for distribution, having been lost through investment misfortune.

Under the usual form of life annuity contract, so long as the insurer is solvent, the contract holder gets the same payment, no matter what may happen to the insurer's investments. The insurer may become insolvent by reason of adverse investment experience alone, but VALIC can *never* become insolvent by reason of adverse investment experience alone. It is the contract holders who will bear the investment losses; and if these are large enough, the individual's losses contingent upon survival to respective payment dates will not be indemnified as *guaranteed* in an annuity contract.

³⁸ Such a statement cannot be found in a true annuity or life insurance contract since the risk of adverse mortality experience is a calculated one taken by an insurer. An insurer's obligation to the insured is contractually fixed upon the happening of the insurable contingency.

³⁹ 312 U.S. 531, 539 (1940). "It is not enough to show that the insurance company assumed 'some' risk. A bank assumes a risk when it accepts a depositor's funds and invests them. The investment may prove to be an unsafe one, or the bank may have agreed to pay the depositor a higher rate of interest than it can profitably earn on the funds it invests. Indisputably this is a risk. But it is not an insurance risk in the sense explained in the *Le Gierse* case." *Keller v. Commissioner of Internal Revenue*, 312 U.S. 543, 544 (1941).

"Risk-shifting" is legally indispensable to insurance. The potential loss which a conventional annuity shifts to an insurer is not shifted to or assumed by the issuer of a "variable annuity" contract. The purchaser remains saddled with the risks of longevity and risks of equity ownership.

VII. OPINIONS OF THE LOWER COURTS

A. *The District Court*

The District Court found that:

A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and to the repayment or variable annuity period.

The risk of profit or loss on investment is borne by the contract holders.

The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks.

The insurance features of such contracts do not alter the investment characteristics.

In its opinion⁴⁰ the District Court stated that "[t]he logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intent of the Securities Act, and the defendants within the terms and plans of the Investment Company Act." It so found as a conclusion of law. Without making a finding that the "variable annuity" contract is "insurance" and its sale "the business of insurance," the District Court denied the injunction because: (1) VALIC was chartered as an insurance company; and (2) its "variable annuity" contracts had been approved by the Insurance Superintendent of the District of Columbia and by the insurance departments of three states (West Virginia, Kentucky and Arkansas). From this premise the court reasoned that the provisions of the McCarran-Ferguson Act exempted the contract and its sale from compliance with the Federal securities laws.

B. *The Court of Appeals*

On appeal none of the parties excepted to the trial court's Findings of Fact.

The Court of Appeals said that:

... the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last.

It then went on to show that the risk is *not shifted* by the "variable annuity" contract by saying:

The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hope to buy when they paid their premiums.

⁴⁰ 155 F. Supp. 521 (D.D.C. 1957).

That fact seems to us to be inherent in the nature of this experiment in annuity contracts.

In affirming the District Court, in an opinion⁴¹ unsupported by reference to case law or other authorities, the Court of Appeals failed to find or hold that the "variable annuity" contract is "insurance" or an "annuity." It found that the sale of "variable annuity" contracts is a "novel" arrangement, a "new business" which "resembles insurance." Paying no heed to the substance of the contracts, the court attached controlling weight to approval of the contracts by the Superintendent of Insurance for the District of Columbia and the insurance commissioners of three states. It did not indicate that it had given consideration to the expert opinion of the SEC that the contracts are securities. Instead of adjudicating the legal issue presented as to whether the contracts are in substance a "security" or "insurance" the court supported its conclusion on its assertion that there is an economic need for such contracts, and that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance."

VIII. THE SUPREME COURT OPINION

The foregoing sections of this article by no means state all the law or exhaust all the arguments on the issues which were presented during the course of the litigation. For example, the philosophy, legislative history and reported key cases of the federal securities laws, much of which appears in the Supreme Court's opinions, has been omitted. As stated before, this article attempts to picture by the use of a broad brush the economic development of the "variable annuity," what it is and the legal atmosphere which led to the ultimate determination that its legal character is that of a "security." The "variable annuity" is not *all* "security;" it is shaded by "insurance." But the trappings of insurance did not blind the Court to its substance as an investment contract and registerable security.

The Court's logic in reaching the conclusion that the "variable annuity" is a "security" can be succinctly summarized:

1. The term "insurance" when used in a Federal statute is a "federal term"⁴² and must be interpreted "as it has commonly been conceived of in popular understanding and usage."⁴³
2. The "variable annuity" is not insurance because the risk of loss contingent on longevity is not shifted to the issuer.⁴⁴
3. The "variable annuity" is a "security" because it "places all the investment risks on the annuitant, none on the company."⁴⁵

The opinion also dispels a common misinterpretation of the McCarran-Ferguson Act; namely, that insurance companies are exempted from federal jurisdiction. That Act exempts only "the business of insurance," which all lexicographers agree is the business of making insurance contracts. The Court held that, "[t]he question common to the exemption provisions of the

⁴¹ 257 F.2d 201 (D.C. Cir. 1958).

⁴² 359 U.S. at 69.

⁴³ *Id.* at 73.

⁴⁴ *Id.* at 71.

⁴⁵ *Ibid.*

Securities Act and the Investment Company Act and to § 2(b) of the McCarran-Ferguson Act is whether respondents are issuing contracts of insurance."⁴⁶

The concurring opinion⁴⁷ sets forth in more detail the legislative history of the federal securities law and the jurisdiction of the states in the insurance field, and analyzes the provisions of the specimen "variable annuity" contract.⁴⁸ It should be carefully read by those interested in the theory of statutory construction as well as those interested in the subject of "variable annuities."

The dissenting opinion of Mr. Justice Harlan⁴⁹ would leave "regulation of the business of insurance exclusively to the States."⁵⁰ Yet it does not define what it means by "insurance."⁵¹ The reader is left with the impression that the dissenters are of the opinion that any contract labelled "insurance," regardless of its substance, is exempted from Federal jurisdiction by reason of the McCarran-Ferguson Act.

IV. FUTURE PROBLEMS FLOWING FROM THE SUPREME COURT'S OPINION

The Supreme Court's opinion is not a panacea for the legal problems attendant on the "variable annuity." It is only a catalyst.

Let us look at some of the problems that flow from the finding that the "variable annuity" is a "security":

1. In the pay-in period it appears beyond dispute that the activities of the issuer bring it within the definition, in the Investment Company Act, of an "open-end" investment company⁵² since the issuer stands obligated to redeem "units" held by a purchaser. There is no such repurchase obligation in the pay-out period.

. . . [T]he investor, during the pay-out period, is in almost every way as much a participant in something equivalent to an investment trust as in [the pay-in period] . . . [T]he individual payment is still a payment measured basically in the same way as one's interest in an investment trust is measured. And in a very real sense the investor is more vitally interested in the investment experience of the company at this period than he ever was in the pay-in period, and in a way more vitally than any holder of an open-end investment company certificate, or share in a publicly traded closed-end company ever is: he has become completely 'locked in.' He obviously cannot draw down the present value of his 'units' once the option to receive annuity payments has been exercised; he cannot 'cash in his chips' that he bought in the faith of the management of the fund; his rights are technically assignable, but practically unmarketable since they depend on his individual life span. The company can radically change investment policies, change advisers, do what ever it pleases . . . and there is nothing the contract holder can do about it.⁵³

⁴⁶ *Id.* at 68.

⁴⁷ By Mr. Justice Brennan, joined in by Mr. Justice Stewart.

⁴⁸ *Id.* at 73-93.

⁴⁹ Concurred in by Justices Frankfurter, Clark and Whittaker.

⁵⁰ 359 U.S. at 100.

⁵¹ Throughout the opinion the phrase "the business of insurance" is repeated time and time again without any attempt to resolve the pivotal issue in the case — what is the meaning of the term "insurance" when used undefined in a Federal statute?

⁵² 54 Stat. 789 (1940); 15 U.S.C. §§ 80a-5(a) (1952).

⁵³ Concurring opinion of Mr. Justice Brennan, 359 U.S. at 88-89.

The question raised is whether the SEC has the power to use its broad dispensing powers⁵⁴ to deny the contract holder, during the pay-out period, the protections of the Investment Company Act which the Congress prescribed for the protection of the investor, the public and in the public interest.

2. Exempted from the Investment Company Act are insurance companies whose "primary and predominant business activity is the writing of insurance."⁵⁵ In the test case the respondents' primary and predominant business was admittedly the sale of "variable annuities." Consequently, even though they were chartered as insurance companies they were held to be non-exempt. But, consider the situation where a large insurance company such as the Prudential, whose primary and predominant business is the writing of insurance, might issue "variable annuities." It seems clear that the Prudential would be required to comply with the Securities Act. Would it, however, be exempt from complying with the Investment Company Act, thus denying to investors the protections of the Act?

3. The Securities Exchange Act of 1934 requires over-the-counter brokers and dealers in securities to register with the SEC. They must maintain appropriate records and file statements of financial condition and be subject to inspection at any time by the SEC and to denial or revocation of registration in certain contingencies. There are general provisions outlawing fraud. The SEC has a considerable amount of rule-making authority. Will the issuers and sellers of "variable annuities" be required to comply with the provisions of this act? Does the SEC have authority to promulgate rules peculiar to the "variable annuity?"

4. In a state in which the "variable annuity" comes within the statutory definition of an "annuity" and is subject to the general insurance laws, with which it cannot comply because of statutory restrictions on investments in equities, will the state permit "variable annuities" to be sold to its citizens as securities?

5. In a state in which the "variable annuity" is subject to and complies with the general insurance laws, will its sale be taxed as insurance by the state and as a security transaction by the federal government?

6. Will the capital gains and other income of the "variable annuity" investment fund be subject to the federal taxes applicable to investment funds?

7. Where the "variable annuity" scheme is employed for a group pension plan, will it qualify for the favorable Federal tax rate applicable to such plans? If so, will individual "variable annuities" be treated differently, tax-wise, than such group plans?

8. In their briefs and arguments before the Supreme Court in the test case, the respondents advanced the academic suggestion that the "variable

⁵⁴ The SEC's dispensing authority in regard to the Investment Company Act is found in § 6(c), which provides: "The commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

⁵⁵ 54 Stat. 789 (1940) § 3(c)(3), 15 U.S.C. 80a-3(c) (1952); and 54 Stat. 789 (1940) § 2(a)(17), 15 U.S.C. 80(a)-2(a)(17) (1952).

annuity" scheme could be brought within the insurance concept by guaranteeing an insignificant fixed amount to the purchaser upon the occurrence of the insurable contingency of longevity plus an uncertain additional amount to be determined by the issuer's month to month investment experience. This they attempted to equate to participating insurance. *In vacuo* the guaranteed fixed payment upon the occurrence of the contingency would appear to be insurance. But, to add to this hope of gain from the issuer's investment experience may well change the legal character of such a contract. In the first place "dividends"⁵⁶ paid to holders of participating insurance policies are wholly within the discretion of the insurer's board of directors.⁵⁷ Secondly, state insurance laws require that if a "dividend" is declared it must be equitably distributed among the insured in like status. Economically, the premium cost of such a contract as compared to its fixed return might well make it unsalable to the public.⁵⁸ Legally, if the issuer promotes such a contract holding out the hope of gain to be realized with relation to a participation in the issuer's investment experience, will he thus bring the contract within the Securities Act definition of a "security"?⁵⁹

Conclusion

It may be conceded freely that the "variable annuity" contract may be one of great potential benefit to the public. If one ignores the fallibility of management, it is possible that those who have a pro rata interest in a "variable annuity" fund *might* realize an increase in the value of their interest which *might* alleviate some of the financial liabilities of inflation. Attainment of the objective, however, is speculative inasmuch as the "variable annuity" scheme, admittedly, does not assure such a result. Man has not yet created an economic plan that will insure against the vagaries of inflation; it seems unlikely that he ever will.

Newton's Laws of Motion tell us that for every action there must be an equal and opposite reaction. Magnetic forces are aligned positive and negative. Interpolating these physical principles in empirical economics, the hope of gain is always accompanied by the risk of loss. So it is in the "variable annuity."

No honestly conceived and intelligently worked out offering of "variable annuities" will be injured by the revelation of the whole truth required by the federal securities laws.

⁵⁶ In the insurance business the word "dividend" is to some extent a misnomer, the "dividend" on a participating policy being partly in the nature of a refund and not altogether a return on investments as the term is generally used in commercial transactions. See HUEBNER, *op. cit. supra* note 31, at 300; MACLEAN, LIFE INSURANCE 148, n.1 (8th ed. 1957).

⁵⁷ "Dividends" on participating policies are not necessarily attributable to the insurer's investment experience. They are paid out of surplus funds which, *inter alia*, may result from loadings in the premium rate pricing proving to be more than sufficient to provide for expenses and contingencies. HUEBNER, *op. cit. supra* note 31, at Ch. XXIX.

⁵⁸ See 359 U.S. at 90 (concurring opinion).

⁵⁹ See SEC v. W. J. Howey Co., 328 U.S. 293 (1946); and SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943), in which the Court held that it is the substance, not form, of the contract that is determinative of its legal character.